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SUBJECT: SPAIN'S UNDERGROUND ECONOMY

REF: A. MADRID 736

1B. MADRID 604

11. (SBU) SUMMARY: Several European researchers have published studies outlining the problem of Spain's underground economy.

The most recent study, published by Friedrich Schneider in March 2004, claims that Spain's underground economy is currently equivalent to 22.3% of official GDP. Spain's continually high unemployment and illegal immigration have accompanied the incidence of significant informal economic activity. Unreported labor and income are more prevalent in predominantly unskilled sectors such as agriculture, construction, and some services. The European Commission (EC) criticized the GOS in 2002 for its lack of coordination in dealing with underground economic activity, observing that the GOS tends to react to easily observable offenses instead of proactively seeking preventative measures. Spain seems to benefit from tolerating at least some underground economic activity and is unlikely to combat it in the near future.  
END SUMMARY

#### THE SIZE OF THE PROBLEM

12. (U) Published in March 2004, Friedrich Schneider's study entitled "Shadow Economies around the World: What Do We Know?" surveys the economic landscape of 110 so-called shadow or underground economies. The underground economy is defined as "those economic activities and the income derived from them that circumvent or otherwise evade government regulation, taxation or observation." In 2003, Spain's informal sector summed to 22.3% of official GDP, making it the third largest of OECD countries only surpassed by that of Italy and Greece. While common perception is that underground economic activity is undesirable, Schneider found that an increase of 1% in the underground economy of an industrialized country results in a 0.8% increase in the official GDP. His analysis showed that an increasing burden of taxation and social security contributions combined with greater state regulatory activities are the driving forces behind the growth and size of the shadow economy.

13. (U) A 2001 study on the Spanish underground economy conducted by the Institute of Fiscal Studies of the Spanish Department of Treasury in cooperation with the Universidad Complutense de Madrid estimated Spain's underground economy to be 20% of GDP. The report analyzes the growth of Spain's shadow economy over a twenty-year period on a regional basis. It shows that over the last two decades, Spain's underground economy expanded from 15% to 20% of GDP. Tenerife, Ciudad Real, and La Rioja were provinces with the largest underground economies. Other, earlier studies have calculated Spain's underground economy as ranging from 20% to as high as 40% of official GDP.

14. (U) The EC has also looked at the underground economy in Spain as part of a larger study on the issue in the EU. The EC found that Spain has the second largest informal sector of the then EU-15, surpassed only by Italy. According to this study, the Spanish underground economy is estimated to equal 23% of GNP (7% more than the European Community average) and accounted for 120 billion euros (USD 143 billion at 1 euro = USD 1.19) of undeclared earnings. The EC's study urged Spain to convert illegal employment into legal employment. The study's authors criticized GOS policy for being ill suited to respond to growth in the underground economy, tending to react to the problem rather than consider ways to prevent it. Furthermore, the EC reported that there is little cooperation amongst GOS agencies and instead each agency has its own priorities when it comes to reducing the underground economy.

#### REASONS FOR UNDERGROUND ECONOMY

15. (U) These studies indicate that rising labor costs and high social security taxes are key factors behind underground economies in Europe. In the case of Spain, a confluence of two additional trends helped stimulate high levels of informal economic activity. First, Spain historically has maintained a high unemployment rate (24.2% at its peak in

1994, and currently 11.3%). Second, Spain is a refuge for economic migrants from Latin America and, more recently, Northern Africa. While not all immigrants are destined for the underground economy, statistics of detected illegal workers in Spain reveal that participation of immigrants in the underground economy has increased substantially. By 2001 (the most current statistics available), immigrants represented more than a third of detected illegal workers.

#### SECTORS

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16. (SBU) The sectors that generally have the largest number of workers in the shadow economy are those that require minimal educational and professional formation. This is evidenced in cities like Tenerife, a tourism hub that is in the midst of a construction boom, Ciudad Real province, active in textile production, and La Rioja, an agricultural and leather production center. The studies show that the highest concentration of illegal workers in Spain is in the agriculture, construction, and service sectors. Gayle Allard, an economist at the Institute of Business (Instituto de Empresa) in Spain, opined that undocumented labor is a hidden subsidy for all of these affected sectors. Underground economic activity is beneficial not only for the private sector, but also more profitable for the GOS than enforcing their own tax and immigration laws. The increased amount of immigrant labor in construction is a recent phenomenon linked to Spain's housing boom (reftel B) and the expansion of tourism and hotel construction along the coasts of southern Spain. Allard believes that it is beneficial for the time being to have a subsidized construction sector to help lift Spain out of the recent recession.

#### IMPACT OF UNDERGROUND ECONOMY

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17. (U) An underground economy of approximately 21% of Spanish GDP is roughly equivalent to 130 billion euros (USD 155 billion). This translates into significant unrealized tax revenue for the Spanish government. A large informal sector also creates an atmosphere conducive to other illegal activities such as selling drugs and the piracy of intellectual property goods (e.g. software, CD's, DVD's, videogames, brand name clothing), which are significant problem in Spain (reftel A). Spain's Treasury Department has calculated that the selling of one kilogram (2.2 lbs.) of pirated CD's is five times more profitable than one kilogram of hashish.

18. (SBU) The underground economy also distorts Spain's economic statistics. For example, some studies suggest that as much as one-third of the unemployed are involved in the underground economy. If correct, this would mean that Spain's high unemployment rate is at least partially artificial. If the GOS can, as the EC report urges it to do, transfer underground occupations to the legitimate labor force, this inflated unemployment figure could fall substantially and social security coffers could grow.

#### GOS ACTION AND REACTION

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19. (U) The EC report characterizes Spain's policy toward the underground economy as reactive and uncoordinated. The GOS claims to be combating the problem by investigating illegal employment and unclaimed income cases. For example, in summer 2002, Spain's Department of Treasury dispatched 200 government officials along the coasts of Spain in an attempt to detect illegal employment and tax evasion. If individuals or businesses were suspected of tax fraud, the officials would initiate an investigation of their tax claims. Another inspection conducted by the Spanish Department of Labor had more tangible results, by recuperating 435.5 million euros (USD 520.5 million) in unpaid social security contributions. From January to June of 2002, the Department of Labor found 33,215 underground workers, of which 4,137 were foreigners without work permits. As a result of the inspections, GOS fined businesses 7.3 million euros (USD 8.7 million) and illegal immigrants 25 million euros (USD 29.9 million) for illegal employment.

10. (SBU) While current action has allowed GOS to recover some lost tax revenue and punish employers for illegal labor practices, the current policy is not effective in shrinking the underground economy. Instead of acting in advance to deter unreported employment or employment of illegal immigrants, its policies focus on reaction by giving disproportionate fines to employees instead of employers in the shadow economy. While any action represents a commendable step, the EC suggests that preventative action through coordinated policies would prove to be more successful at reducing the submerged economy. As the EC report found, the policies of the various government agencies are not coordinated. That lack of harmonized policies leaves the government with misaligned goals, resulting in a

governmental principal-agent dilemma. Pilar L'Hotellerie, head of analysis of the Spanish economy for the Bank of Spain, said that although the new socialist government is paying slightly more attention to tax evasion and fraud than the former Popular Party (PP) government, she does not expect to see any form of legislation intended to deter underground economic activity in the foreseeable future.

11.(SBU) COMMENT: The GOS usually turns a blind eye to underground economic activity in traditionally important sectors such as agriculture and construction. Untaxed factors of production act as a hidden subsidy, increasing the country's general economic welfare in sectors where official subsidies are impossible to enact because of GOS-EU trade obligations. In many of these markets Spain is in direct competition with low labor-cost producers, and without these hidden subsidies domestic firms would exit. There is no question that the underground economy has contributed to Spain's remarkable economic growth since joining the EU. Absent budgetary pressures or stronger EC urging to curb such activity, we see no change in the role or size of Spain's underground economy in the near future. END COMMENT  
ARGYROS